Why did Neoliberalism Triumph and Endure in the Post-Communist World?

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No region has embraced neoliberalism as enthusiastically and persistently as post-Communist Europe and Eurasia. The widespread adoption of neoliberal policies in the former Communist world over the last twenty-five years is unparalleled in speed and scope. This sustained embrace overturns conventional wisdom about the politics of economic reform in transition countries. At the outset of transition, scholars and practitioners anticipated a host of political, cultural, and institutional obstacles to liberalization in Eastern Europe and Eurasia. In particular, they emphasized the incompatibility of sudden democratization and economic liberalization.[1] Leading theorists such as Adam Przeworski, Ralf Dahrendorf, Jon Elster, and Ellen Comisso predicted that the economic hardship accompanying the introduction of capitalism would lead the electorate to vote out reformers.[2] At a minimum, neoliberal reform programs would be abandoned. At worst, new democracies would suffer a rise in populism, xenophobia, or a reversion to authoritarianism.[3] Either democracy or liberal economic reforms would have to go. An alternative theory suggested that neoliberal reforms would be undermined not by the "losers" but the "winners" of transition, powerful interest groups that benefited handsomely from rents from incomplete reforms.[4] Both theories converged, though, in expecting neoliberal economic reforms to be stalled or reversed. Cognizant of these challenges, economic reformers believed they needed to push through neoliberal reforms during a brief "window of opportunity" before "normal politics" re-emerged.[5] Others thought that the cultural legacies of Communism would slow or prevent citizens from overcoming decades of paternalism.[6] Few in the region remembered life before Communism; it would be difficult to promote a capitalist work ethic, entrepreneurism, a culture of self-reliance, and the rule of law.[7] Given the vast extent of state ownership, the frequent irrelevance of money and prices, an outdated infrastructure, low productivity, and a lack of competition, it seemed unlikely that neoliberal reforms would endure.[8]

Yet, most post-Communist countries defied expectations as they continued to adopt neoliberal policies for decades after the "window of opportunity" created by the political transitions of 1989–91 had been expected to close. While Jeffrey Sachs claimed that "you cannot cross a chasm in two jumps,"[9] a number of Eastern European and Eurasian countries

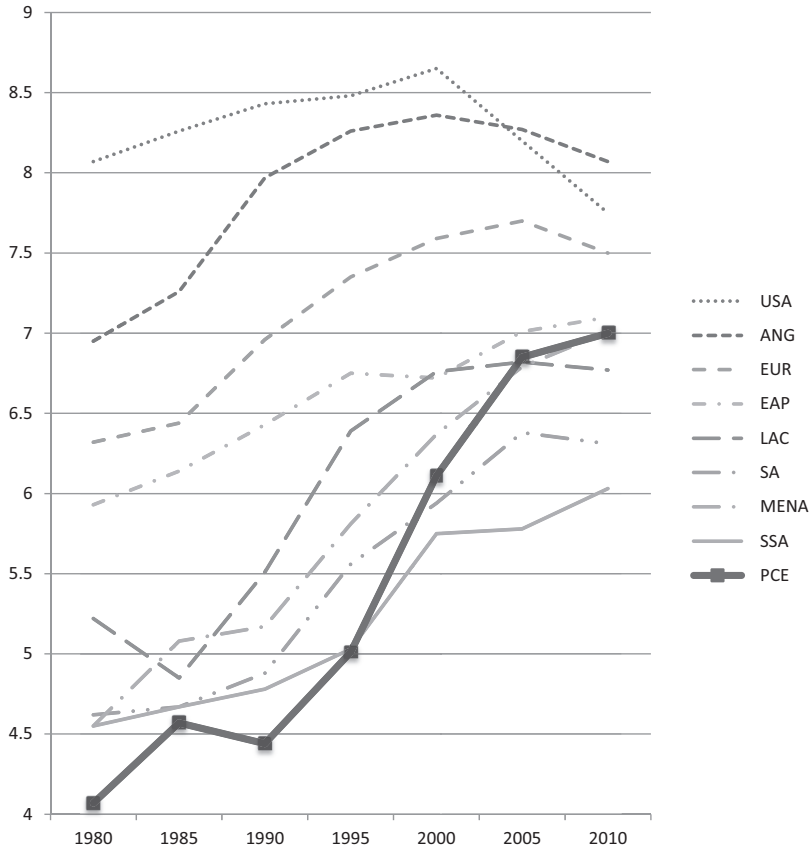
liberalized in two or even three jumps. Countries like Poland set the pace starting in 1990, but even laggard Balkan countries such as Serbia and Croatia managed to liberalize dramatically (albeit much later) despite punishing wars and political miscues. Eastern European and Eurasian countries continued to reform far longer than political economists predicted, under governments of widely varying political stripes. Hungary launched its most dramatic reform effort, the Bokros Package, not in 1990, but in 1996,[10] under a Socialist government. Russia initiated the "Gref program," a major liberalization effort that included the introduction of a flat tax, under President Vladimir Putin in the early 2000s.[11] President Nursultan Nazarbayev in Kazakhstan saw through a series of privatization reforms, including industrial privatization, small-scale and housing privatization in the mid 1990s, and enacted liberal land reform in the late 1990s after several failed attempts. Kyrgyzstan also carried out privatization in a series of steps over the 1990s and was one of the earliest Eurasian countries to join the World Trade Organization (WTO) in 1998, followed by Georgia in 2000 and Armenia in 2003.[12] Political, cultural, and economic conditions in these countries did not prevent a sustained neoliberal transformation including the privatization of state-owned enterprises, the development of a new private sector, the emergence of markets for the allocation of resources, and freer movement of goods and capital, though they shaped distinctive varieties of capitalism and affected the pace of reforms.[13] Newfound political freedoms were seldom used to reverse neoliberal reforms;[14] instead, neoliberalism prevailed time and again in these nascent polities under a wide variety of political and economic circumstances.

Neoliberal reform in post-Communist Europe and Eurasia went on longer and progressed further than most analysts expected. Not only did most governments in the 1990s implement the policies of the Washington Consensus, which included privatization, macroeconomic stabilization, and trade and price liberalization, they also continued to liberalize into the early 2000s in preparation for membership in the European Union, or, in some former-Soviet countries, for reasons discussed below. While EU membership encouraged liberalization in prospective new member states,[15] Eastern European and Eurasian countries often pursued even more radical neoliberal reforms than the EU advised, including the flat tax, pension privatization, slashing corporate tax rates, extreme monetarism, and central bank independence. Some of these avant-garde neoliberal policy reforms had failed under the political, economic, and cultural constraints of most of the established market economies of Western Europe and North America, but were widely adopted in Eastern Europe and parts of the former Soviet Union. The surprising strength and endurance of the region's embrace of neoliberal policies remains one of the great unexplained mysteries of the transition.

One way to look at the progress of neoliberal economic policies in a country is to start with a general definition of "neoliberal" or "liberal" economic policies, such as trade liberalization, monetarism, or fiscal prudence, establish an index or a scale, and rate countries as more or less liberal over time. This method has been adopted by neoliberal think tanks such as the American Heritage Foundation and the Fraser Institute of Canada, which publish indices of liberalization or "economic freedom" for countries around the world. According to data collected by the Fraser Institute, by the mid-2000s, Eastern

European and Eurasian countries no longer lagged behind others in economic freedom. Some, like Estonia, were global leaders in economic liberalization. The Fraser Institute's Index of Economic Freedom shows that Eastern European and Central Asian countries started from a lower level of liberalization than other developing countries, but progressed

Figure 1 Liberalization 1980–2010 by World Region



Source: Fraser Institute.

USA = United States of America
ANG = Anglophone Settler Countries minus USA plus UK
EUR = European Countries (minus Post-Communist Europe)
EAP = East Asian and Pacific Countries, LAC = Latin American Countries
SA = South Asian Countries
MENA = Middle East and North African Countries
SSA = Sub-Saharan African Countries
PCE = Post-Communist European Countries including Europe and Central Asia.

rapidly in the 1990s and 2000s (see Figure 1). By 2005, the average level of liberalization in Eastern Europe and Central Asia had converged with that of other highly liberal and liberalizing regions, such as East Asia Pacific and the Latin American countries.[16] A similar picture is painted by Simmons, Dobbins, and Garrett,[17] whose data show that Eastern Europe and Central Asia caught up with other developing regions in financial openness and exceeded them all in privatization revenues during the 1990s and early 2000s.

Yet, in some respects, this approach understates the fervor with which Eastern European and Eurasian countries embraced neoliberal reforms. Going beyond the original Washington Consensus or EU policies, Eastern European and Eurasian countries adopted a range of avant-garde neoliberal reforms in the 2000s such as pension privatization and the flat tax that made them a testing ground for neoliberal ideas.

To account for the unexpected, fervent, and sustained embrace of neoliberalism in Eastern Europe and parts of Eurasia, as well as signs of a possible decline after 2008, we divide the neoliberal transformation into three overlapping phases: Washington Consensus, European Accession, and Avant-Garde. In analyzing these three periods, each of which captures a different dynamic of reform, we elucidate domestic sources of liberalization as well as the role that Western and international actors played as initiators, promoters, or exemplars of change. We further consider whether the momentum has waned following the shocks to the European political economy after 2008.

A key factor in Eastern Europe and Eurasia's embrace of neoliberalism, and especially avant-garde neoliberalism, has been a dynamic of adopting neoliberal reforms as a signal to impress potential investors and attract capital. In the 1990s, Eastern Europe and Eurasia lagged behind other developing regions by a decade in a race to liberalize economic policies. China, for instance, began to liberalize its economy in the late 1970s and began to receive massive foreign capital inflows in the 1980s. Desperate to attract capital to revive their devastated economies, policymakers in Eastern Europe and Eurasia seemed to believe that the adoption of neoliberal policies would help minimize perceptions of a Communist legacy and show that a new era of investor-friendly regulation had begun. The urgency of such reforms was heightened by the simultaneous emergence of twenty-seven post-Communist countries in the 1990s. Post-Communist countries competed for investment not only against international powerhouses such as China and India, but also among themselves. As these countries were continuously rated against one another by international organizations such as the European Bank for Reconstruction and Development, the World Bank, and the European Commission—all of whom adopted hegemonic neoliberal ideas throughout the 1990s and early 2000s—countries came under intense pressure to exceed others in neoliberal reform adoption and avoid backtracking.

Competitive signaling began to wane in 2008 as Eastern Europe and Eurasia achieved higher levels of openness than other developing regions and experienced disappointments with the effects of neoliberal policies. Alternative development strategies helped to shatter the hegemonic position of the neoliberal paradigm. While many works have emphasized differences in the ways that neoliberal policies have been implemented in different states, forming distinct varieties of capitalism,[18] this article

provides a comprehensive explanation of the main trend and the great puzzle of transitional economic theory: the enduring triumph of neoliberalism and its belated decline after 2008.

The Momentum Behind Neoliberalism

In order to understand the momentum behind neoliberalism over two decades, it is necessary to specify how we use the term "neoliberalism." First, despite its negative connotation in much of the transition literature, we use the term neutrally. We define neoliberalism as a transnational policy paradigm, a set of ideas about economic policy linked to a political program aimed to develop market economies throughout the developed and developing worlds.[19] These ideas derived from a long line of liberal economic thinking, but are most closely associated with the anti-statist and anti-Keynesian work of Friedrich Hayek, the monetarist economic theory of Milton Friedman, and the University of Chicago economics department. The "Chicago school" emphasized the primacy of markets for determining value and for distributing resources. It discouraged government intervention except to ensure the functioning of markets (e.g., to enforce contracts, protect property rights, and ensure physical safety). It asserted that unfettered trade would lead to efficiency gains and welfare improvements, and state regulation would generally diminish public welfare. After the collapse of the post-war Keynesian consensus and the oil shocks of the 1970s, neoliberal ideas suddenly came to dominate economic thinking in the leading states in the world system when they were adopted by leaders such as Margaret Thatcher in Great Britain and Ronald Reagan in the United States,[20] as well as General Augusto Pinochet in Chile. Neoliberal ideas then spread to the rest of the world through the influence and pressure of these leaders and leading states.[21] Countries that opposed neoliberal ideas risked punishment by financial markets and political isolation. Neoliberal ideas came to dominate Eastern Europe and Eurasia only after the collapse of Communism in 1989–91, approximately ten years later than elsewhere in the world. The adoption and diffusion of neoliberal policies in Eastern Europe and Eurasia took place in three phases driven by different dynamics, but overlapping somewhat in time.

The Washington Consensus Phase When the former Soviet bloc countries in Eastern Europe opened to the world economy, it quickly became clear that they did not have much choice whether to adopt neoliberal policy reforms. Leading Western governments and international organizations were dominated by a neoliberal policy agenda, and they held the resources and mechanisms to export these ideas to the rest of the world. The only real questions for post-Communist countries to decide were to what extent they would adopt neoliberal policies and how fast.[22] Eschewing neoliberalism, as Belarus, Myanmar, and Venezuela showed, was a choice that courted isolation and geopolitical risk. As Czech Premier Klaus at the time famously quipped, he saw the "third way" as the "fastest way to the Third World."[23] The imperative to adopt neoliberal reforms was especially

pressing for the small, open economies of East-Central Europe, which sought a geopolitical realignment from East to West. In order to "return to Europe," countries had to adopt Western advice proffered through a range of agencies from the IMF and World Bank to the G24, to the European Union with its PHARE program, to the OECD. Governments of both the left and the right adopted a set of neoliberal reforms summed up by many as "the Washington Consensus," a term previously denoting the core set of liberal economic policies that the main international financial institutions, the IMF and the World Bank, agreed upon and advocated for Latin America in the 1990s.[24]

For the most part, these programs included the immediate freeing up of prices (with a few exceptions like housing, energy, and transport), liberalization of trade, introduction of convertible currencies, lifting of capital controls, and elimination of state subsidies to firms. In the earliest years of post-Communist transition, proponents of a radical neoliberal approach referred to the strategy as "shock therapy," which in retrospect was an ill-chosen term for its advocates, as it encouraged comparisons with a discredited psychological treatment.[25]

The Washington Consensus also encouraged the privatization of enterprises. However, in contrast to other developed and developing countries, privatization in Eastern Europe and Eurasia was a monumental undertaking. In 1989, the private sector in the Communist world was miniscule, except in Hungary and Yugoslavia where some private, cooperative, and joint ownership had emerged in the late Communist period or, as in some parts of Polish agriculture, had persisted throughout the Communist period. Post-communist privatization would require not only the transfer of ownership of nearly every small shop, hotel, restaurant, and enterprise, but also the "commanding heights" of the economy, including heavy industry and natural resources.[26] Under Communism, large-scale enterprises were entirely state-owned. A new approach was needed to transfer ownership to a relatively poor citizenry and avoid a fire sale to foreigners. Neoliberal economists in the early 1990s, like Václav Klaus in Czechoslovakia and Anatoly Chubais in Russia, favored an avant-garde approach known as "voucher" privatization (or coupon privatization).[27] In essence, citizens would receive vouchers for free or at a nominal cost that they would then exchange for shares in state-owned enterprises or mutual fund intermediaries. Voucher privatization programs were accompanied by other forms of privatization, including public tenders, auctions, and restitution to former owners.[28] Despite a lack of precedent or evidence supporting the efficacy of this approach, most former Communist countries adopted this avant-garde neoliberal approach.

Although analysts expected electoral politics to get in the way of the early phase of liberalization, Eastern European and Eurasian countries defied expectations by continuing their neoliberal trajectory unabated. Some predictions came true. For example, in some Eastern European countries the electorate voted out early neoliberal leaders, and opposition parties won elections. In many countries, these "second election" governments were dominated by politicians of the left.[29] However, successor governments deviated little from the neoliberal approach. Politicians on the left wanted to prove they were bona fide capitalists.[30] In particular, the three post-Communist Baltic countries remained enthusiastic adopters of neoliberal reforms regardless of whether the left

or the right was in power. Elsewhere, in Poland, Hungary, and the Czech Republic, the left came to power in the early and mid-1990s, but did not undermine neoliberalism, despite promises to do so. Under Premier Vladimír Mečiar, Slovakia displayed authoritarian tendencies and cancelled some planned reforms, such as the second round of voucher privatization. However, while Slovakia lagged behind its neighbors for half a decade, it ultimately surpassed them in the years following Mečiar's ouster when key actors like Mikuláš Dzurinda and Ivan Mikloš gained top positions in government and formed a center-right government committed to far-reaching neoliberal reform.[31] In Romania, former Communists dominated the government after the first free election,[32] and some aspects of economic and political liberalization were slow to take off. Yet, the involvement of the international financial institutions (IFIs) in both Romania and Bulgaria in 1997 and 1998 sped up the adoption of Washington Consensus policies. Former Soviet countries, including Russia, had less electoral turnover and more authoritarian tendencies, which led to more patchy adoption of neoliberal reforms. Yet, even in these countries, neoliberal reforms were adopted over time. Ukraine, which resisted neoliberal reforms throughout the 1990s and early 2000s, more actively pursued them after the Orange Revolution and then in 2014–2015, under pressure from the IMF.

There were exceptions within this trend, with more limited neoliberal transformations in Azerbaijan, Tajikistan, and Uzbekistan.[33] Nonetheless, the overarching trend for the post-Communist world was clear: the sustained embrace of the neoliberal programs of the Washington Consensus. Despite predictions of diverted or stunted reform, with electoral turnover or not, with democratic or authoritarian governments, neoliberalism took the region by storm. Nearly all countries progressed towards neoliberalism, though some started earlier and progressed more swiftly and completely (and with less backtracking) than others.

Europeanization and Liberalization In the mid-1990s, prominent economist Jeffrey Sachs argued that the return of former communist parties to government constituted a challenge to reform.[34] Sachs wrote that the longer-than-expected honeymoon period following the collapse of Communism was over and that politicians would lose support and credibility. Indeed, politicians could no longer rest on their anti-communist legitimating status to justify painful but (seemingly) necessary measures. Moreover, as the 1990s ended, the geopolitical motivations for adopting capitalist institutions in some Eastern European countries—to cement the country's Western identity and differentiate the country from Russia—were less urgent, since some of these countries had joined NATO in 1999 (with a second wave following in 2004).

More broadly, in the late 1990s, the neoliberal paradigm outside the post-Communist world was being challenged. The Asian Financial Crisis of 1997–98 caused a growing disenchantment with neoliberalism. Many blamed economic openness for dramatic economic contractions and massive capital flight out of the developing world.[35] The international crisis prompted a reconsideration of key aspects of neoliberalism, such as the lifting of capital controls, full convertibility of currencies,

and lightly regulated financial sectors. Moreover, China's ability to withstand the crisis, not to mention its extraordinary record of growth, gave new credence to an alternative model of state capitalism.[36]

Yet liberalization in much of Eastern Europe continued to be driven by one overpowering motivation: the incentive of EU membership. Vachudova's seminal study on EU enlargement shows how the enticement of full membership in the EU served to advance neoliberal programs in countries like Bulgaria, Romania, and Slovakia.[37] Even where neoliberal reforms benefited from the local support of strong and well-placed advocates, like in the Czech Republic and Poland, the EU was an important actor helping to "complete" the unfinished implementation of privatization and liberalization.

Accession to the European Union required that Eastern European countries address any incomplete areas of liberalization, such as in the area of large enterprise privatization.[38] The European Commission's yearly progress reports assessing a country's readiness for membership were surprisingly precise in identifying which sectors to address and even named specific companies and banks to privatize prior to accession. For example, the 2000 progress report on Romania states:

> Although Romania has liberalised prices and trade to a large extent, the markets for land and capital are not yet fully established and do not function properly. The absence of a sound and well-functioning financial system hinders economic development. There is an urgent need to continue with the full implementation of the programmes agreed with the International Financial Institutions and the EU, in particular the privatisation of large enterprises and liquidation of unviable ones.[39]

Similar passages can be found in the reports of all Eastern European candidate countries in the years leading up to membership. In the Czech Republic, slow progress in privatizing the financial sector threatened to delay EU accession as well as deregulation of the coal, gas, and telecommunications sectors.[40] In Poland, the EU required privatization of steel, gas, chemicals, distilleries, power, pharmaceuticals, telecommunication services, and sugar prior to accession.[41] In Latvia, the EU required privatization of several industries such as shipping, telecommunications, and energy, as well as the reduction of agricultural tariffs.[42] In Bulgaria, the EU required privatization of the financial sector, land, energy, and telecommunications, and tariff reduction on agricultural and industrial products.[43] Sznajder Lee shows how the steel sector in the Czech Republic and Poland was transformed through strong EU pressure for privatization.[44]

During the EU accession negotiations, no mainstream political party wanted to be perceived as hindering progress in achieving EU membership. A clear consensus emerged among major Eastern European political parties that they must do whatever required to become full members of the European Union. Students of Eastern European political parties have noted almost no variation between the programmatic platforms of the left and the right during the election campaigns in the late 1990s and early 2000s.[45] Instead, parties portrayed themselves as more effective at achieving the changes required for membership. The EU thus accelerated the completion of many partially realized neoliberal programs begun during the Washington Consensus phase.

Avant-garde Neoliberalism and Second Stage Reforms As powerful as the EU membership conditionality was for advancing liberalization in East Central Europe, it cannot explain what some have called Eastern Europe's "second stage reforms" in a broad array of post-Communist countries.[46] The neoliberal project intensified in Eastern Europe in ways that are clearly distinct from the EU membership conditionality. Some hyper-liberalizing programs spread well after the accession negotiation process was complete and affected countries without interest or a serious prospect of EU membership. Second stage reforms include pension privatization, the flat tax, and slashing of corporate tax rates. These programs went well beyond anything required for EU accession. In the mid-1990s, they spread to the Baltic countries, and in the mid-2000s they reached East and Central Europe and many other parts of the former Soviet bloc.[47]

Pension privatization, a new paradigm in pension system governance and organization, came to Eastern Europe via Latin America, where it had been adopted by many countries following the 1980–81 Chilean reforms. Between 1998 and 2004, fourteen post-Communist countries partially or fully privatized their social security type pension systems and implemented systems of individual, private pension savings accounts. Given the distributional consequences and political sensitivities surrounding pension privatization and that the EU neither required nor encouraged pension privatization, its implementation by eight of ten post-Communist new member states is quite extraordinary. Pension privatization was also adopted by countries not aspiring to EU membership such as Russia, Kazakhstan, and Uzbekistan.

In the case of pension privatization, it was the World Bank and a coalition of other IFIs and bilateral aid agencies that promoted reform rather than the EU. The World Bank not only developed a template for reform, but also supported its dissemination with advisory services, subsidies for reform design and implementation, and loans to cover the transition costs of switching to private account systems. Most World Bank lending in support of pension privatization occurred from 1995–2001, when the World Bank lent 5 billion USD for pension reform projects. It extended an additional 2 billion USD in loans between 2002 and 2007. Eastern European countries, along with countries in Latin America, received the bulk of these loans. In addition to billions of dollars in lending, the World Bank provided technical assistance to reform teams, training sessions, and career tracks for reform officials. Other organizations, such as the IMF and USAID, participated as well.[48]

East European countries also adopted other hyper-liberal policy ideas not supported by international financial institutions or the European Union, particularly in tax policy. In the span of about a decade, the vast majority of post-Communist countries moved away from progressive taxation to implement some form of a flat tax.[49] A flat tax system levies a single rate of taxation on personal income, regardless of income level (although usually above a minimum threshold). In most cases, the flat tax lowered the top marginal tax rates on personal income, with the exception of Latvia and Lithuania. Typically, the overnight tax cut for those with high incomes was enormous. For example, in Bulgaria the top marginal tax rate fell from 24 percent in 2007 to 10 percent in 2008 while in Slovakia the top rate fell from 38 percent to 19 percent. Russia's top rate fell

from 30 percent to 13 percent, and, even more dramatically, the top marginal tax rates of 40 percent in Ukraine and Kazakhstan fell to 13 percent and 10 percent, respectively.

Under the pro-market and anti-Communist leadership of Mart Laar, Estonia became the first post-Soviet country to introduce the flat tax in 1994. Within three years, both of Estonia's Baltic neighbors followed suit. The Russian Duma adopted a flat tax in 2001, advocated by Vladimir Putin's reform team led by economist German Gref. Many of Russia's neighbors, including Ukraine, Georgia, and Belarus, followed suit. In 2004, the Slovak government led by Mikuláš Dzurinda attracted widespread attention by introducing a flat tax rate of 19 percent on personal income, corporate profits, and consumption (VAT). Much of his reform team became flat tax advisors abroad. With great enthusiasm, the new Romanian government led by Prime Minister Băsescu rushed to introduce a flat tax just a few days after taking office in late 2004. Bulgaria and the Czech Republic implemented a flat tax in 2007 and 2008; and in 2010 the Hungarian parliament voted to adopt the flat tax for 2011. Three Central Asian countries adopted a 10 percent flat tax: Turkmenistan in 2005, followed by Kyrgyzstan in 2006 and Kazakhstan in 2007. Even in the exceptional East European countries, such as Poland and Slovenia, where the flat tax was not adopted due to mobilized opposition, income taxes were "flattened" with a significant move away from progressive taxation. Moreover, the former Soviet republics that did not implement a flat tax typically reduced the number of tax brackets and lowered the top marginal rate(s). Azerbaijan and Tajikistan both lowered rates and reduced the number of rates to two, with Tajikistan's top rate reduced to only 13 percent. Armenia also levied only two tax rates until 2012. Uzbekistan still has three tax brackets, but the top rates fell significantly in the 2000s.

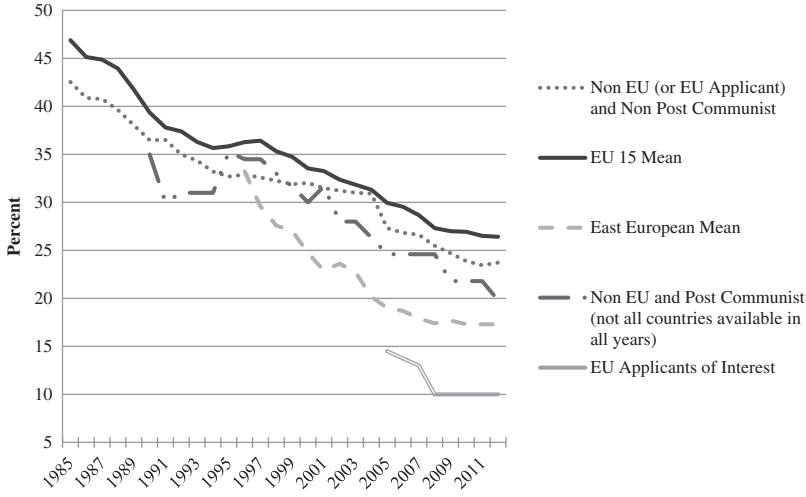
The flat tax was advocated neither by the EU nor the international financial institutions. The IMF's Article IV country missions warned governments that marked reductions in personal income taxes were unaffordable and inadvisable, telling Estonian Premier Mart Laar not to take a measure that could result in severe budgetary shortfalls. In Slovakia, the IMF representatives in the Article IV Consultation in 2003 expressed serious concerns about the budgetary impact of the flat tax and encouraged Slovakia to implement it over three years rather than one.[50] In Romania and Kyrgyzstan, the IMF opposed the flat tax as well.[51] Yet Eastern European and Eurasian countries moved beyond the original neoliberal agenda to adopt these experimental, avant-garde reforms.

Similarly, post-Communist countries have taken the lead in slashing corporate income taxes. While nominal corporate tax rates are falling throughout the world, the cuts in Eastern Europe have been much sharper (see Figure 2).[52] As a result, Eastern European rates are not only low relative to Western Europe, they are also extremely low globally.

Like the flat tax, corporate income tax (CIT) cuts did not arise from pressure by the European Union or the international financial institutions. On the contrary, corporate tax cuts were opposed by some of the most important EU countries, which spoke out against tax competition. Eight of the ten eastern enlargement countries have nominal rates at or below 20 percent, and three have rates at or below 15 percent. Aspiring

post-Communist EU countries offer even lower nominal corporate income tax rates, on average. By comparison, the nominal corporate tax rate at the time of the first wave of enlargement was 35.4 percent in France, 35 percent in Spain, 37.3 percent in Italy, and 38.3 percent in Germany.[53]

Figure 2 Average Corporate Tax Rates



Source: Appel and Block, 2015.

Despite threats from Western European leaders to withhold structural funds from countries with low CIT rates, the commitment to low corporate taxes in Eastern Europe has not waned. The persistence of neoliberal reforms into the 2000s—particularly these avant-garde reforms that went beyond what the EU and IMF were advising—shows the need for a new theoretical perspective on transitional political economy.

Competitive Signaling and the Dominance of the Neoliberal Paradigm

While early analyses of economic transition predicted a short "window of opportunity" for neoliberal reforms based on domestic political-economic tensions, this study views economic policymaking after Communism through the lens of international economic integration. The political economy of Eastern Europe and Eurasia was not driven by the central problem that observers perceived in the 1990s—the problem of the simultaneous transition to democracy and markets. The overarching problem was how to integrate into an increasingly globalized economy, to compete for investment against other developing regions, and to grow economically. Adoption of neoliberal economic ideas provided a path, and seemingly the only viable path, to achieve global integration and economic development.

Eastern European and Eurasian countries competed not only against other developing regions, but also against one another to become low-cost production platforms for the rich markets of Western Europe and the developing markets of Eastern Europe and Eurasia. Former Communist countries started with considerable disadvantages. They were not only late to liberalize, but also much less liberal and integrated than other middle-income countries (see Figure 1). This exacerbated policymakers' strong historical sense of relative "backwardness." Eastern European countries felt a need to race to become more competitive through neoliberal reform and to erase the Communist legacy. Race they did, overcoming a wide variety of political and cultural obstacles to adopt neoliberal policy ideas, though the implementation of these ideas was imperfect and differed from country to country in form, pace, and intensity.[54]

The post-Communist region's aim to become competitive with the rest of the world created a dynamic of competitive signaling. As Campos and Kinoshita put it in an IMF paper on the relation between structural reforms and foreign direct investment, "Many believe that successful implementation of structural reforms by the host government is a positive signal to foreign investors as it implies less investment risk. Thus, the progress of structural reforms can be an impetus to strong foreign investment flows."[55] Raff and Srinivasan show that, "Tax incentives are motivated by the need to signal favorable investment conditions" and that incentives are more likely to be used the larger the investment risk, the smaller the local market, and the smaller the stock of previous FDI,[56] making Eastern European and Eurasian countries prime examples. As Frye, O'Dwyer and Kovalčík, and others have emphasized, an important dimension of neoliberal reform in the post-communist world was to attract much-needed investments of foreign capital.[57] Investors looked carefully for signs of prudent, liberal economic management from Eastern European countries and radical change from the past Communist regimes. As all of these papers show, investors put their money into countries with more neoliberal economic reform efforts.[58] One study shows that adoption of pension privatization was correlated with a 57.4 percent increase in the rate of foreign direct investment per GDP in subsequent years.[59] Another study demonstrates that service sector reforms in telecommunications, power, and transport were highly correlated with inward FDI.[60] Given this, it is understandable that Eastern European and Eurasian policy makers believed that the adoption of neoliberal reforms would encourage foreign investment.

The use of neoliberal economic reforms as signals to investors was accelerated by the large number of countries in the post-Communist European and Eurasian region, all poor in capital and all reforming at more or less the same time. Intense competition helps to explain the rapidity with which avant-garde neoliberal reform ideas such as pension privatization, the flat tax, and super-low corporate income taxes were adopted in a large number of primarily post-Communist countries. Granted, each reform was typically adopted and sold on its specific merits. For example, many governments supported the flat tax as a stand-out market reform that was administratively easy to implement and well-suited to economies with a

substantial shadow economy. However, avant-garde neoliberal reforms also sent signals of investor friendliness and a pro-market orientation and often were adopted without serious analysis of actual impacts. This was particularly the case for avant-garde neoliberal reforms. These became a challenge to neighboring countries to follow suit or be left behind.

During the boom of the early and mid-2000s, the inflow of foreign investment seemed to validate the claims of neoliberal economists. Not only did Eastern Europe and Eurasia liberalize more dramatically than any other region of the world from 1990–2006,[61] the region also experienced the greatest boom in foreign investment over the same period. At the height of the bubble in 2007, IMF data show that Central and Eastern European states had the highest net financial inflows per GDP of any region in the world, outpacing developing Asia and Latin America by a factor of two.[62] The absolute amounts of capital flowing to Eastern Europe exceeded that flowing to emerging and developing Asia, an IMF category that includes both India and China. For a short time, it seemed that neoliberal economic policies had finally triumphed, enabling Eastern Europe to out-compete other world regions in attracting the capital needed for economic development. Output in Eastern Europe and Eurasia, however, declined after 2008 more sharply than in any developing region, as these countries experienced a "sudden stop" of capital flows.[63]

Prior to 2008, one can account for the resilience of the neoliberal project by emphasizing the drive of post-Communist countries to integrate into a global economy in which neoliberal ideas were hegemonic and to become more competitive with other developing regions. Under these conditions, Eastern European and Eurasian countries experienced ineluctable pressures to liberalize their economic policies and became model adopters of neoliberal policy ideas. The fact that Eastern European countries started at least a decade later and from a lower absolute level only exacerbated these pressures. While certain governments embraced reform more than others,[64] nearly all governments responded by pursuing liberalizing reforms. International institutions used their leverage to encourage countries down this path.[65] This sped reform along at certain times. However, at other times, post-Communist governments outpaced the international institutions in the alacrity with which they embraced avant-garde neoliberal reform ideas. This suggests that these countries were not simply "colonized"[66] or coerced, but embraced liberal reforms for other reasons. As a result, most Eastern European and former Soviet countries rapidly achieved high levels of liberalization on par with other middle-income developing regions of the world.

The dynamic of competitive signaling not only helps to account for the unexpected breadth and endurance of the triumph of neoliberalism, it also helps to explain the timing of its decline. After the collapse of Lehman Brothers in 2008, when capital flows to Eastern Europe came to a sudden stop, banks that had financed their debt on spot markets lost access to capital overnight. While the EBRD and European Union made sure that Western European banks did not pull capital out of Eastern Europe to finance deficits at home,[67] the capital inflows to Eastern Europe that reached billions of euros per year in the pre-crisis days suddenly ceased, causing serious economic damage and

output declines. Soon after, some countries began to question and even back away from neoliberal reforms, as international financial institution economists questioned the wisdom of a neoliberal growth model based on external finance.[68]

One prominent example is Hungary.[69] Formerly a leading neoliberal reform country, elections in 2010 brought to power a government that initiated a new "Eastern winds" approach to economic policy that emphasized state intervention to grow the national economy through the establishment of national champions and a national capitalist class. It was coupled with a less-than-liberal approach to democratic governance. Hungary punished Western banks that had loaned to its citizens mortgages denominated in foreign currency and forced them to convert these loans to forints at a disadvantageous fixed rate. This cost foreign banks billions of euros and caused them to divest Hungarian holdings. Hungarian Premier Viktor Orbán indefinitely postponed Euro adoption, cancelled pension privatization, and criticized the IMF. Negotiations for an IMF crisis package for Hungary repeatedly broke down in 2010, 2011, and 2012, as Orbán articulated a financial nationalist position that attacked multinational companies and foreign banks as contrary to the interests of the Hungarian people. Johnson and Barnes argue that the Orbán government "sought to maintain and increase its financial sovereignty, the ability to fund the projects it valued when it decided to do so" and succeeded in the face of international pressure.[70]

While Hungary is sometimes described as an outlier, other Eastern European countries curtailed the adoption of neoliberal policies after 2008 in the face of rising economic nationalism. In Poland, the highly-durable, economically liberal government of Donald Tusk took a moderate approach to reforms, eschewing avant-garde liberalism. His government initiated a reversal of pension privatization and adopted a fiscal stimulus program in 2009, using the automatic stabilizers of the social welfare system. Rather than undertake avant-garde reforms like the flat tax as outlined in its electoral platform, Tusk's government adhered to the "normal" politics that former Finance Minister Balcerowicz had feared. The Law and Justice government in Poland, elected in 2015, promised to reverse more neoliberal reforms. In a similar vein, Slovakia backtracked both on the flat tax and pension privatization after 2009, diminishing the effect of both reforms. Russia introduced a range of protectionist trade measures during Putin's second and third terms as president, including a ban on Western agricultural inputs following the crisis with Ukraine in 2014. The Czech Republic reintroduced progressive taxation, and Bulgaria and Latvia have also come close to backtracking on the flat tax. Fraser Institute data point to a marked reduction in the trend towards neoliberalism in the whole post-Communist European and Eurasian region in the second half of the 2000s (Figure 1).

Competitive signaling, driven by a perception among policymakers that the adoption of neoliberal economic policies would bring foreign investment and growth, helps to explain not only the enduring embrace of neoliberalism in Eastern Europe and Eurasia after 1989–91; it also explains signs of a decline of adherence to neoliberalism in the region after 2008, when the massive capital inflows that had previously rewarded these policies suddenly stopped.

Conclusion

Given the truly radical reordering of the political and economic system, the high number of internal political hurdles to overcome, and the domestic economic starting conditions, the sustained momentum behind neoliberal reform in post-Communist Eastern Europe and Eurasia raises crucial questions. Why did the many domestic hurdles not prove decisive in blocking reforms? Why did reforms endure far past the "window of opportunity" identified in the early 1990s? Why did neoliberalism continue throughout the process of EU accession and exceed what even the EU and IFIs were demanding of these countries, before losing steam at the end of the 2000s?

While scholars have uncovered significant diversity in the implementation of neoliberal policies in Eastern Europe and explored different varieties of capitalism in the region, we focus here on understanding the common driving forces behind the main vector of reform in Eastern Europe: the enduring neoliberal transformation. We develop an argument that differs from previous theories of neoliberal reforms in Eastern Europe. We suggest that the main problem that these countries faced was reinsertion into the international economy as a means of gaining adequate investment in the economy, not domestic political-economic dynamics. This reinsertion into a highly competitive international economy by a large number of post-Communist countries explains the surprisingly robust commitment to economic liberalization over nearly two decades, in defiance of prior expectations.

Given their relative backwardness in economic liberalization, their late starting point, the intensity of competition from East Asia, the hegemony of neoliberal ideas, and the large number of post-Communist countries competing with one another, Eastern European countries faced seemingly unavoidable pressures to liberalize to gain the attention of foreign investors. These pressures drove a process of competitive liberalization that lasted far longer than observers predicted and encouraged a strong embrace of neoliberal ideology. International organizations supported this effort at key points. For instance, the EU forced Eastern European countries to continue liberalization as a criterion of accession in the late 1990s. But a number of reforms enacted in Eastern Europe outpaced even what was demanded by the IFIs or EU, with the flat tax and corporate tax cuts as particularly potent examples. These experimental policies were powerful signals, as their economic effects were largely unknown and they demonstrated a willingness to take chances to impress potential investors.

By 2008, Eastern Europe and many countries in Eurasia had become as economically liberal as other middle-income countries. Yet unexpectedly, the tremendous financial flows that had encouraged liberalization suddenly dried up. Moreover, China's ability to withstand the crisis gave new credence to an alternative model of state capitalism. After 2008, several statist deviations from neoliberal policy began to appear. Eastern European countries began losing their enthusiasm for avant-garde neoliberal ideas and started to backtrack, as in the cases of Hungary, the Czech Republic, Slovakia, Poland, Ukraine, and Russia. A dynamic of attracting foreign investment through competitive signaling can explain both the surprising

endurance of neoliberal reforms in Eastern Europe and Eurasia since 1989, as well as their belated decline.

NOTES

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